
AG CREDIT AGRICULTURAL CREDIT ASSOCIATION

2003 ANNUAL REPORT

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Management

Neil Jordan	President and Chief Executive Officer
Alice Beers	Secretary/Treasurer
Mark Pepple	Vice President – Corporate Services
Bruce Leimbach	Vice President – Marketing
Clem Prenger.....	Internal Auditor

Board of Directors

Dennis Schroeder	Chairman
Tom Antesberger.....	Vice Chairman
Melvin Boecher	Director
Charles Bostdorff	Director
Gerald Bumb	Director
Harold Dalton.....	Director
Allen Hartschuh	Director
Edison Klingler	Director
Merrel Lust.....	Director

Message from the Chairman of the Board and Chief Executive Officer

Your lending cooperative continued successfully pursuing its business objectives in 2003, to:

- ◆ Grow its market share
- ◆ Strengthen its credit quality
- ◆ Effectively manage its risks; and,
- ◆ Strengthen its capital base to support growth

With your continued support your cooperative will continue to grow, prosper, and add to your farm or agribusiness's profitability. With competitive interest rates coupled with our patronage program of distributing profits to you, your total net cost of borrowed funds are the lowest possible. In 2003, over 21% of your interest paid was assigned for your patronage distribution.

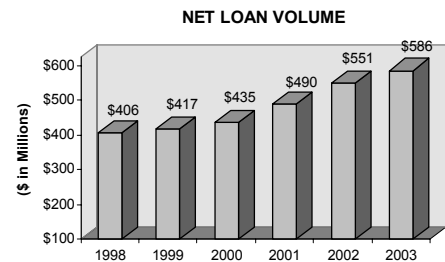
AG CREDIT continues to flourish due to these primary reasons:

- ◆ Your dedicated use of AG CREDIT when you have a need for borrowed capital
- ◆ Your referrals to others; and,
- ◆ Your Board and Employees dedication to planning, service, and continuous improvement

Thanks to your continued use and referrals to friends and neighbors, AG CREDIT continues to flourish and grow and achieve favorable financial results. The following charts reflect our progress:

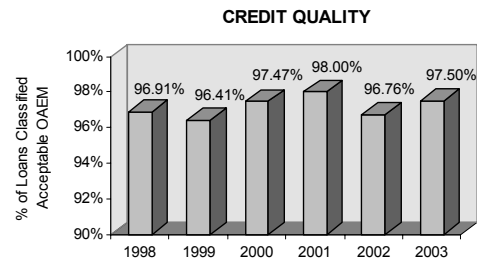
Loan Volume

Our volume of business continues its upward swing as more farm families and agribusinesses join our cooperative. Despite declining numbers of farmers, we have had the good fortune of increasing our market share and adding 88 new borrowing entities in 2003. We believe that our new borrowers are clearly seeing the value their cooperative brings.



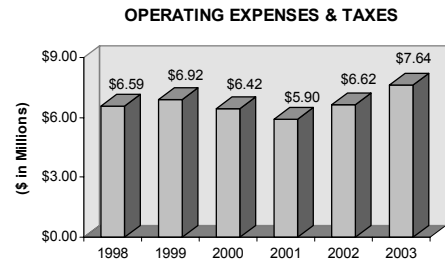
Risk Management

Our credit quality of 97.5% ticked back up to our near record pre-drought high of 2001. Much of our servicing territory has now seen the worst of years, and the best of years. Who would have thought they would be back-to-back? It was an excellent corn, soybean, wheat, nursery, greenhouse, beef, poultry, and egg production year. Stronger commodity prices are also contributing to your cooperative's uptick in quality.



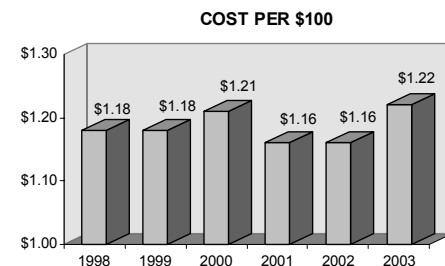
Operating Expenses

Our annual expenses are undeniably, up. The increases have been led by health benefit costs, retirement trust contributions, and FCSIC insurance premiums on our loan base. With stock market improvement, we anticipate some relief from retirement contributions, however, health benefits will continue to be a challenge. Our volume of business has offset these rising costs.

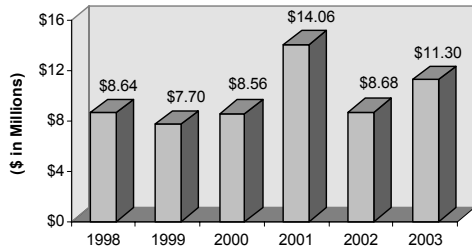


Cost Per \$100

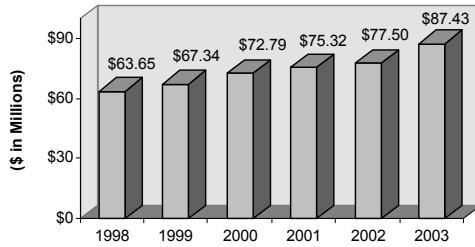
Our containment of expenses coupled with volume growth have contributed to a favorable trend in lowering our cost per \$100 loaned. Similar to your business's cost/bushel, cost/flat, or other unit, cost per \$100 loaned reflects our "unit measurement".



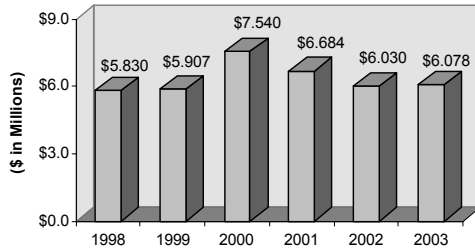
FINAL NET EARNINGS



NET WORTH



PATRONAGE REFUNDS



Profitability

Net earnings rebounded this year due to three primary factors: continued business development, a fixed rate re-pricing effort, and an increase in income from noninterest sources. The lower interest rate environment continues to hinder our net income, however Stockholders benefit, up front, with lower interest rates. As you review this trend, please remember the substantial increase in 2001 was caused by our favorable IRS tax refund of approximately \$5 million that year.

Capital

Similar to your business' net worth, your association needs equity to provide economic stability, coverage for risks that are inherent in lending money, and to provide for an allowance for potential losses. Our net worth continues to grow in proportion to our volume growth, and we were able to add to our capital from earnings and additional capital retention in 2003. We are well poised for future growth and risk coverage.

Patronage Refunds

We are the only lender that returns profits to you, which sets your cooperative apart from the rest. Over the long term, with an attractive rate up front, cash patronage, plus an anticipated allocated reserve revolvment, your cooperative continues to be the most attractive source of funds possible. (2003 total is estimated patronage distribution approved by the Board.)

We believe that this report continues to reflect that your cooperative rewards your ownership by adding value to you. With competitive interest rates, plus a distribution of operational profits, which equated to >21% of total interest paid in 2003, your net cost of borrowed funds are very favorable.

Your dedicated Board and Staff are driven to continue to deliver your credit and services in as effective, efficient, and financially responsible manner as possible.

When you think about it, what structure or delivery system could be better for farmers and agribusinesses? Our borrowers, directors, and employees are all involved with farming and agribusiness. Who knows better what farmers and agribusinesses need?

We appreciate having you as a member of AG CREDIT, and truly value the relationship we have with you. We pledge to do our part to add value to your continued financial progress.

Dennis Schroeder
Chairman of the Board

Neil L. Jordan
Chief Executive Officer

February 19, 2004

Report of Management

The accompanying consolidated financial statements and related financial information appearing throughout this annual report have been prepared by management of Ag Credit Agricultural Credit Association (the Association) in accordance with generally accepted accounting principles appropriate in the circumstances. Amounts which must be based on estimates represent the best estimates and judgments of management. Management is responsible for the integrity, objectivity, consistency, and fair presentation of the consolidated financial statements and financial information contained in this report.

Management maintains and depends upon an internal accounting control system designed to provide reasonable assurance that transactions are properly authorized and recorded, that the financial records are reliable as the basis for the preparation of all financial statements, and that the assets of the Association are safeguarded. The design and implementation of all systems of internal control are based on judgments required to evaluate the costs of controls in relation to the expected benefits and to determine the appropriate balance between these costs and benefits. The Association maintains an internal audit program to monitor compliance with the systems of internal accounting control. Audits of the accounting records, accounting systems and internal controls are performed and internal audit reports including appropriate recommendations for improvement, are submitted to the Board of Directors.

The consolidated financial statements have been examined by independent public auditors, whose report appears elsewhere in this annual report. The Association is also subject to examination by the Farm Credit Administration.

The consolidated financial statements, in the opinion of management, fairly present the financial condition of the Association. The undersigned certify that the 2003 Annual Report has been prepared in accordance with all applicable statutory or regulatory requirements and that the information contained herein is true, accurate, and complete to the best of our knowledge and belief.



Dennis Schroeder
Chairman of the Board



Neil L. Jordan
Chief Executive Officer



Alice M. Beers
Chief Financial Officer

February 19, 2004

Consolidated Five - Year Summary of Selected Financial Data

(UNAUDITED)

<i>(dollars in thousands)</i>	2003	2002	December 31, 2001	2000	1999
Balance Sheet Data					
Cash	\$ 363	\$ 110	\$ 547	\$ 915	\$ 171
Loans	597,523	561,446	499,059	443,141	423,867
Less: allowance for loan losses	11,042	10,262	8,803	7,729	6,979
Net loans	586,481	551,184	490,256	435,412	416,888
Investment in AgFirst Farm Credit Bank	4,206	4,206	4,206	4,206	4,206
Other property owned	—	—	38	—	—
Other assets	17,329	18,202	17,950	20,531	18,784
Total assets	\$ 608,379	\$ 573,702	\$ 512,997	\$ 461,064	\$ 440,049
Notes payable to AgFirst Farm Credit Bank*	\$ 511,870	\$ 485,258	\$ 428,810	\$ 379,234	\$ 363,975
Accrued interest payable and other liabilities with maturities of less than one year	9,075	10,947	8,872	9,037	8,736
Total liabilities	520,945	496,205	437,682	388,271	372,711
Protected borrower equity					
Capital stock and participation certificates	12,270	8,908	9,217	14,774	15,271
Retained earnings					
Allocated	33,503	27,254	24,768	20,538	15,280
Unallocated	41,661	41,335	41,330	37,481	36,787
Total members' equity	87,434	77,497	75,315	72,793	67,338
Total liabilities and members' equity	\$ 608,379	\$ 573,702	\$ 512,997	\$ 461,064	\$ 440,049
Statement of Income Data					
Net interest income	\$ 14,657	\$ 12,530	\$ 12,949	\$ 12,723	\$ 12,264
Provision for (reversal of) loan losses	840	1,500	2,000	750	600
Noninterest income (expense), net	(2,515)	(2,348)	3,107	(3,409)	(3,961)
Net income	\$ 11,302	\$ 8,682	\$ 14,056	\$ 8,564	\$ 7,703
Key Financial Ratios					
Rate of return on average:					
Total assets	1.90%	1.62%	2.96%	1.95%	1.76%
Total members' equity	13.61%	11.19%	18.86%	12.08%	11.76%
Net interest income as a percentage of average earning assets	2.53%	2.41%	2.85%	3.05%	2.91%
Net chargeoffs (recoveries) to average loans	0.01%	0.01%	0.20%	—	0.001%
Total members' equity to total assets	14.37%	13.51%	14.68%	15.79%	15.30%
Debt to members' equity (:1)	5.96	6.40	5.81	5.33	5.53
Allowance for loan losses to loans	1.85%	1.83%	1.76%	1.74%	1.65%
Permanent capital ratio	14.91%	13.47%	15.09%	15.95%	14.93%
Total surplus ratio	12.67%	11.81%	13.18%	12.56%	10.81%
Core surplus ratio	11.57%	9.40%	10.34%	10.44%	9.38%
Net Income Distribution					
Cash dividends declared/paid	\$ 158	\$ 131	\$ 209	\$ 287	\$ 267
Estimated patronage refunds:					
Cash dividend	\$ 2,444	\$ 2,294	\$ 2,247	\$ 2,262	\$ 1,959
Qualified allocated surplus	1,629	1,235	1,210	5,278	3,948
Nonqualified allocated surplus	2,005	2,501	3,227	—	—
Nonqualified retained surplus	4,678	2,501	3,227	—	—

* General financing agreement is renewable on two-year cycles. The next renewal date is December 31, 2004.

Management's Discussion & Analysis of Financial Condition & Results of Operations

(dollars in thousands, except as noted)

The following commentary reviews the financial condition and results of operations of Ag Credit Agricultural Credit Association (Association) for the years ended December 31, 2003 and December 31, 2002. This information should be read in conjunction with the financial statements, notes to the financial statements and other sections in this annual report.

Stockholder 2003 net earnings and balance sheets will reflect renewed and much needed strength after the devastating impact of the 2002 drought. Corn and wheat yields were very favorable with soybean yields at average to slightly below average. Net farm earnings for the cash grain farmers will be positively impacted by the favorable yields and steady to stronger commodity prices. Government support payments to farmers increased in 2003 primarily due to 2002 disaster payments. This is not anticipated to continue for 2004 due to the improved cash grain yields and commodity prices experienced in 2003. Off-farm employment remains stable in most sectors of the Association's territory and will continue to support Ag Credit's stockholders. Livestock, milk and egg producers have also experienced a positive earnings year with meat, eggs and dairy commodity prices coming in above average. Nursery and bedding plant producers also have had positive earnings with favorable consumer response in 2003.

The favorable conditions described above have allowed the Association's credit quality to remain strong. Non-earning assets decreased during 2003 as a result of payments made on loans in this non-earning asset status. Management feels the Association continues to be well positioned to work through difficult times with our members as we have in the past.

The Association continues to increase its new loan closings and volume, although volume growth for 2003 slowed in comparison to 2002. In addition, over the past year the Association purchased and sold loan participations. During 2003, the Association targeted certain segments of our business with hopes of increasing market share. The targeted segments included loans to young, beginning and small farmers. In addition the Association increased the use of FSA loan guarantees which assist the Association to better leverage its capital, mitigate its commodity (cash grain) concentration risk, and reduce the Association's potential risk of loss on loans. By utilizing guarantees, the Association can help ensure its ongoing profitability, better serve the agricultural communities in our territory and return more value to our member stockholders.

Continued efforts are being made to expand services, increase public knowledge of our services and streamline current delivery of products to enhance our existing portfolio. We continue to emphasize our relationships with existing stockholders, referrals from our membership, and our long-term commitment to agriculture. By operating as a cooperative and returning the majority of our earnings to our stockholders in the

form of patronage refunds and allocated surplus revolvment, we continue to obtain new business, and anticipate this to continue into the future.

We expect competition from regional and local commercial banks to continue. Additional competition for operating loans will come from seed, fertilizer and chemical companies as they seek to add credit as an additional company profit center. However, the Association remains very competitive and has continued to be successful in gaining market share. Our stockholders recognize the advantage of doing business with a cooperative, which results in reduced net borrowing costs due to the sharing of our profits. We continue to look for ways to streamline our credit delivery system, expand our services and tell the cooperative story to add quality loans to our current portfolio.

Looking ahead to 2004, stockholders will likely benefit from improved cash grain prices with cash grain futures at the highest level in recent years. A weaker U.S. dollar and increased demand for cash grains should improve grain exports. However, there is still increasing competition from grain growing countries in South America. We anticipate that stockholder income from government payments will be reduced in 2004. The higher grain prices will likely have an adverse effect on the hog/corn and steer/corn feeding ratios. The current fervor over the "mad cow" disease will have a significant adverse affect on beef prices. However, this will have little impact on the Association as a whole. While this scare will hurt the beef industry within our territory, it could have a positive impact on the pork and poultry portion of the Association's portfolio should people change their protein demand habits.

LOAN PORTFOLIO

The Association provides funds to farmers, rural homeowners, and farm-related businesses for financing of short and intermediate-term loans and long-term real estate mortgage loans. The geographic distribution of the loans is as follows:

Branch	12/31/03	12/31/02
Findlay	10.0%	9.8%
Fremont	9.1	9.1
Tiffin	9.4	9.1
Bowling Green	9.1	9.5
Marion	6.0	6.0
Bucyrus	7.2	7.2
Kenton	5.6	5.7
Mt. Gilead	7.3	7.0
Upper Sandusky	4.5	4.6
Norwalk	13.2	13.9
Ottawa	7.9	7.2
Van Wert	3.3	3.2
Napoleon	4.4	4.6
Admin	3.0	3.1
	100.0%	100.0%

The diversification of the Association loan volume by type is shown below:

Loan Type	12/31/03	12/31/02
Long-term farm mortgage	50.1%	48.3%
Production and intermediate-term	38.3	41.0
Rural home	6.8	4.6
Farm-related business	1.3	1.7
Processing and marketing	0.3	0.2
Nonaccrual	0.7	0.9
Finance leases	0.4	0.6
Participation loans purchased	2.7	3.1
Less: participations sold	(0.6)	(.4)
	100.0%	100.0%

The Association's loan portfolio is diversified over a range of agricultural commodities in our region. Predominant commodities in the portfolio are general cash grains (primarily soybeans, wheat and corn), livestock and horticulture that constitute over 81 percent of the entire portfolio. Please refer to Note 3 in the Notes to the Financial Statements section of this annual report for additional information concerning the loan types and loan portfolio.

The gross loan volume of the Association as of December 31, 2003, was \$597,523, an increase of \$36,077 or 6.43 percent as compared to \$561,446 at December 31, 2002. Net loans outstanding on December 31, 2003, were \$586,481 as compared to \$551,184 at December 31, 2002. Net loans accounted for 96.4 percent of total assets on December 31, 2003 as compared to 96.1 percent of total assets at December 31, 2002.

The increase in both gross and net loans during the reporting period is attributed to increased demand for long-term farm mortgage and rural home loans. For the past few years, the Association has experienced a shift in loan assets. The percentage of long-term farm mortgage volume has increased while the production and intermediate-term loan volume trend showed a slight decrease. The production volume, which is heavily influenced by operating-type loans, normally increases during the summer months and declines in the fall months as commodities are marketed and proceeds are applied to repay operating loans. In December, this part of the portfolio increases as farmers prepay operating expenses. This trend continued in 2003.

During 2003, the Association continued its activity in the buying and selling of loan participations within and outside of the Farm Credit System (FCS). This provides a means for the Association to spread credit concentration risk and realize non-patronage sourced interest and fee income, which may strengthen our capital position. As of December 31, 2003, the Association had \$10,465 in participation loans purchased from other FCS institutions, \$5,464 in participation loans purchased from non-FCS institutions, offset by \$4,572 in participation loans sold.

The Association sells qualified long-term home mortgage loans into the secondary market. For the period ended December 31, 2003, the Association originated loans for resale totaling \$1,074, which were sold into the secondary market.

The Association's loan portfolio is divided into performing and high-risk categories. Association Credit, Special Assets

Management and branch staff are all responsible for servicing loans classified as high-risk. The high-risk assets, including accrued interest, are detailed below:

	12/31/03	12/31/02
High-risk Assets		
Nonaccrual loans	\$ 4,409	\$ 5,320
Restructured loans	546	584
Accruing loans 90 days past due	—	1,516
Total high-risk loans	<u>4,955</u>	<u>7,420</u>
Total high-risk assets	<u>\$ 4,955</u>	<u>\$ 7,420</u>
Ratios		
Nonaccrual loans to total loans	.74%	.95%
High-risk assets to total assets	.81%	1.29%

Nonaccrual volume decreased by \$911 due to collections made on loans in nonaccrual status. Nonaccrual loans as a percentage of total loans decreased from .95 percent to .74 percent. An increase in nonaccrual loans could produce unfavorable results in the Association's operations. There are no significant potential credit risks within the loan portfolio that could adversely impact the performance of the loan portfolio in the near future.

Loan restructuring is available to financially distressed borrowers. Restructuring of loans occurs when the Association grants a concession to a borrower based on either a court order or good faith in a borrower's ability to return to financial viability. The concessions can be in the form of a modification of terms or rates, a compromise of amounts owed, or deed in lieu of foreclosure. Restructured loans may also involve other receipts of assets and/or equity to pay the loan in full or in part. The type of alternative financing structure chosen is based on minimizing the loss incurred by both the Association and the borrower.

There is an inherent risk in the extension of any type of credit. Association management analyzes credit quality, loan performance, concentration, and other forms of risk, maintaining an allowance for loan losses in an amount sufficient to absorb possible losses in the loan portfolio based on current and expected future conditions. As previously indicated, the Association uses FSA guarantees to help manage credit risk inherent in the Association's loan portfolio and to help reduce the potential for future loan losses. The Association made an addition of \$840 to the allowance for loan losses in 2003. Charge-offs for the period ended December 31, 2003 amounted to \$60, for a net increase to the allowance of \$780. The ratio of net charge-offs to average loans was .01 percent at December 31, 2003. The allowance for loan losses at December 31, 2003 totaled \$11,042, which was 1.85 percent of total loans outstanding and was considered by management to be adequate to cover possible losses. Please refer to Note 2 in the Notes to the Consolidated Financial Statements of this Annual Report for further information concerning the allowance for loan losses.

In June 2003, the American Institute of Certified Public Accountants' Accounting Standards Executive Committee (AcSEC) issued a proposed Statement of Position (SOP) – Allowance for Credit Losses, which was intended to clarify the methodology for estimating the allowance for credit losses and to enhance financial statement disclosures related to the allowance for credit losses. In January 2004, AcSEC dropped its proposed SOP and announced that it would focus instead on improving financial statement disclosures in this area.

System institutions plan to conduct studies to further refine their methodologies, including what are currently acceptable and permissible under generally accepted accounting principles, focusing specifically on the Securities and Exchange Commission and Federal Financial Institutions Examination Council guidelines. Such a study would likely be completed by the fourth quarter of 2004 with any appropriate changes to the allowance for loan losses implemented at that time.

RESULTS OF OPERATIONS

Net income for the year ended December 31, 2003, totaled \$11,302, an increase of \$2,620 or 30.18 percent, as compared to \$8,682 for the same period of 2002. Major components of the changes in net income for the past two years are outlined in the following table.

Changes in Net Income:

	<u>2003-2002</u>	<u>2002-2001</u>
Net income (prior year)	\$ 8,682	\$ 14,056
Increase (decrease) in net income due to:		
Interest income	595	(4,738)
Interest expense	1,532	4,319
Net interest income	2,127	(419)
Provision for loan losses	660	500
Noninterest income	847	(717)
Noninterest expense	(1,072)	(750)
Benefit (provision) for income taxes	58	(3,988)
Total changes in income	<u>2,620</u>	<u>(5,374)</u>
Net income	<u>\$ 11,302</u>	<u>\$ 8,682</u>

The significant increase in net income is primarily attributed to improved earnings on loan assets. During 2003, a significant portion of the Association's fixed rate loan portfolio re-priced, taking advantage of the lower interest rate environment. This resulted in lower rates for the Association's member borrowers and improved earnings spreads for the Association.

Net interest income increased by \$2,127 or 16.98 percent in 2003 compared to 2002. Interest income on loans increased by \$595 despite the lower interest rates in 2003. This increase resulted primarily from the Association's increase in loan volume for 2003 as compared to 2002, which was offset by lower market interest rates. Interest expense decreased by \$1,532 when compared to 2002. This significant decrease is related to the decrease in the Association's average borrowing cost on its notes payable to the AgFirst Farm Credit Bank (the Bank), which was offset by the increase in the average notes payable during 2003. The significant loan re-pricing activities experienced during 2003 and the lower general market interest rates resulted in this decrease in borrowing costs. Please refer to the Five-Year Summary of Selected Financial Data in this annual report to review key financial ratios pertaining to earnings and net interest income. Changes in net interest income are influenced by changes in loan volume, interest rates, nonaccrual income and loan purchased discount income. The table shown below illustrates the approximate effect that each of these factors had on the changes in net interest income for 2003 and 2002, respectively. The sources of change in net interest income are illustrated, as follows:

Change in Net Interest Income:

	<u>Volume*</u>	<u>Rate</u>	<u>Nonaccrual Income</u>	<u>Loan Purchase Discount Income</u>	<u>Total</u>
12/31/03 – 12/31/02					
Interest income	\$ 3,581	\$ (2,790)	\$ (176)	\$ (20)	\$ 595
Interest expense	2,228	(3,760)	—	—	(1,532)
Change in net interest income	<u>\$ 1,353</u>	<u>\$ 970</u>	<u>\$ (176)</u>	<u>\$ (20)</u>	<u>\$ 2,127</u>
12/31/02 – 12/31/01					
Interest income	\$ 5,027	\$ (9,151)	\$ (370)	\$ (244)	\$ (4,738)
Interest expense	3,335	(7,654)	—	—	(4,319)
Change in net interest income	<u>\$ 1,692</u>	<u>\$ (1,497)</u>	<u>\$ (370)</u>	<u>\$ (244)</u>	<u>\$ (419)</u>

* Volume variances can be the result of increased loan volume or from changes in the percentage composition of assets and liabilities between periods.

Noninterest income for the period ended December 31, 2003, increased \$847 or 19.82 percent as compared to the same period of 2002. The increase is primarily attributed to a \$229 increase in loan fee income, a \$135 increase in fees for financially related services and a \$445 increase in the patronage refund from the Bank. Income from the patronage refund from the Bank increased as a result of the increase in the Association's average notes payable to the Bank for 2003. In 2002 and 2003, the Bank made special capital distributions to the Association of \$218 and \$257, respectively. Reference the "Funding Sources" section below for further discussion on the changes in the Association's notes payable to the Bank. Income from financially related services increased primarily due to increased income from multi-peril crop insurance, crop hail insurance and credit life insurance income. Loan fee income increased as a result of fees from new loans (primarily rural home type loans) and loan servicing fees. The increase in loan servicing fees resulted from loan re-pricing activities primarily during the first nine months of 2003.

Noninterest expense (operating expenses) increased \$1,072 or 16.73 percent for the twelve months ended December 31, 2003, as compared to the same period of 2002. The increase is primarily due to a \$631 increase in salaries and employee benefits, a \$477 increase in the Farm Credit System Insurance Corporation premium expenses offset by a \$36 decrease in occupancy and equipment expense. Salary and benefit expenses increased due to normal salary increases and related benefits, annual leave expense as well as significant increases in pension expenses, health care premiums and post-retirement health care costs. In 2003, the significant increase in the rate on Insurance Fund premiums and Association loan volume resulted in a significant increase in premiums expense.

The Association recorded a provision for income taxes of \$155 for 2003 as compared to \$213 for the twelve months ended December 31, 2002.

A key factor in the growth of net income for future years will be continued improvement in net interest and noninterest income. Our goal is to generate earnings sufficient to fund operations, adequately capitalize the Association, and achieve a strong rate of return for our members. To meet this goal, the Association must attract and maintain high quality agricultural and home loan volume priced at competitive rates and to manage credit risk in our entire portfolio, while efficiently meeting the credit needs of our members.

LIQUIDITY AND FUNDING SOURCES

Liquidity

Liquidity management is the process whereby funds are made available to meet all financial commitments including the extension of credit, payment of operating expenses and payment of debt obligations. The Association receives access to funds through its borrowing relationship with the Bank and from income generated by operations. The Association's participation in the secondary market programs provides additional liquidity. Sufficient liquid funds have been available to meet all financial obligations.

Funding Sources

The principal source of funds for the Association is the borrowing relationship established with the Bank through a General Financing Agreement. The General Financing Agreement utilizes the Association's credit and fiscal performance as criteria for establishing a line of credit on which the Association may draw funds. The Bank advances the funds to the Association, creating notes payable to the Bank. The notes payable are segmented into variable rate and fixed rate sections. The variable rate note is utilized by the Association to fund variable rate loan advances and operating funds requirements. The fixed rate note is used specifically to fund fixed rate loan advances made by the Association. The total notes payable to the Bank at December 31, 2003, were \$511,870 as compared to \$485,258 at December 31, 2002. The increase of 5.48 percent during the period is attributable to the increase in loan volume, the payment of \$2,292 of cash patronage to members in April and the cash payment of \$1,935 of the qualified allocated surplus in September.

The Association had no lines of credit outstanding with third parties as of December 31, 2003.

Funds Management

The Bank and the Association manage assets and liabilities to provide a broad range of loan products and funding options, which will permit the Association to be competitive in all interest rate environments. The primary objective of the asset/liability management process is to provide stable, consistent earnings, while maintaining adequate capital levels by managing exposure to credit and interest rate risks.

Demand for loan types is a driving force in establishing a funds management strategy. The Association offers fixed, adjustable and variable rate loan products that are marginally priced according to financial market rates. Variable rate loans may be indexed to either the Prime Rate or the 90-day London Interbank Offered Rate (LIBOR). Adjustable rate mortgages are indexed to U.S. Treasury Rates. Fixed rate loans are priced based on the current cost of Farm Credit debt of similar terms to maturity.

The Association's net interest income as a percentage of average earning assets (net interest margin) was 2.53 percent on December 31, 2003, compared to 2.41 percent on December 31, 2002. The change is mainly attributed to increased interest spreads on loans.

The majority of the interest rate risk in the Association balance sheet is transferred to the Bank through the notes payable structure. The Bank, in turn, actively utilizes funds

management techniques to identify, quantify and control risk associated with the loan portfolio.

CAPITAL RESOURCES

Total members' equity at December 31, 2003 was \$87,434. This represents an increase 12.82 percent or \$9,937 from the December 31, 2002, total of \$77,497. The increase is from net income and an increase in capital stock and participation certificates partially offset by cash patronage and the revolvment of allocated retained earnings.

Total capital stock and participation certificates were \$12,270 on December 31, 2003, compared to \$8,908 on December 31, 2002. This 37.7 percent increase is attributed to the \$3,158 increase in Class A stock and a \$204 increase in c-stock and participation certificates.

Allocated equities increased by \$6,249 or 22.9 percent from \$27,254 at December 31, 2002 to \$33,503 on December 31, 2003. In September 2003, the Association revolved \$2,073 of qualified allocated equities primarily related to the 1998 patronage refund. The revolvment is half of the 1998 qualified allocated equities. It is anticipated that the remaining portion of the 1998 qualified allocated equities will be paid out in 2004 pending Board approval. The ACA subsidiary structure provides for the patronage refund to be distributed in cash, qualified allocated retained earnings, nonqualified allocated retained earnings and nonqualified retained earnings. The December 31, 2003 allocated equity balance includes allocated equities from the 2003 estimated patronage refund as follows: \$1,629 of qualified allocated retained earnings, \$2,005 of nonqualified allocated retained earnings and \$4,678 of nonqualified retained earnings.

The Association's permanent capital ratio as of December 31, 2003 was 14.91 percent compared to 13.47 percent on December 31, 2002. Farm Credit Administration (FCA) regulations require all Farm Credit institutions to maintain a minimum permanent capital ratio of 7 percent. The permanent capital ratio is calculated by dividing the Association's permanent capital by a risk-adjusted asset base. The permanent capital position increased due to increased guarantee volume, improved earnings and increased A-stock. FCA regulations also require all Farm Credit institutions to maintain two other minimum capital ratios: total surplus ratio of 7 percent and core surplus ratio of 3.5 percent. The total surplus and core surplus ratios are calculated by dividing total surplus and core surplus as defined in FCA regulations by a risk-adjusted asset base. As of December 31, 2003, the Association's total surplus ratio and core surplus ratio were 12.67 percent and 11.57 percent, respectively, as compared to 11.81 percent and 9.40 percent, respectively, on December 31, 2002. The increase in these ratios is primarily related to improved earnings, slowed revolvment of allocated equities and increased allocated retained earnings.

Annually, the Association establishes target capital ratios. The Association's 2003 target permanent capital ratio was between 12 and 16 percent of risk-adjusted assets. The targeted total surplus and core surplus ratios for 2003 were greater than 10.0 percent and greater than 7.0 percent, respectively. As of December 31, 2003, the Association was within the permanent capital ratio target and exceeded both the total surplus ratio and the core surplus ratio targets.

Disclosure Required by Farm Credit Administration Regulations

Description of Business

Descriptions of the territory served, persons eligible to borrow, types of lending activities engaged in, financial services offered and related Farm Credit organizations are incorporated herein by reference to Note 1 to the consolidated financial statements, "Organization and Operations," included in this annual report to stockholders.

The description of significant developments that had or could have a material impact on earnings or interest rates to borrowers, acquisitions or dispositions of material assets, material changes in the manner of conducting the business, seasonal characteristics, and concentrations of assets, if any, is incorporated in "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in this annual report to stockholders.

Description of Property

The following table sets forth certain information regarding the properties of the reporting entity, all of which are located in Ohio:

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
610 W. Lytle St. Fostoria	Administrative	Owned
7868 County Rd. 140, Ste. A Findlay	Branch	Leased ⁽¹⁾
2155 Oak Harbor Rd. Fremont	Branch	Owned ⁽²⁾
1200 N. St. Rt. 53 Tiffin	Branch	Owned
111 E. Gypsy Lane Rd. Bowling Green	Branch	Owned
602 W. Lytle St. Fostoria	Country Mortgages	Owned
1100 E. Center St. Marion	Branch	Owned
3113 St. Rt. 98 Bucyrus	Branch	Owned
12923 St. Rt. 309 Kenton	Branch	Owned
97 Houpt Dr., Room E. Upper Sandusky	Branch	Leased ⁽³⁾
871 W. Marion Rd., Suite 204 Mt. Gilead	Branch	Leased ⁽⁴⁾

<u>Location</u>	<u>Description</u>	<u>Form of Ownership</u>
735 US Rt. 20 E. Norwalk	Branch	Owned
315 W. Williamstown Rd. Ottawa	Branch	Owned
1195 Professional Dr. Van Wert	Branch	Leased ⁽⁵⁾
1485 N. Scott St., Suite 210 Napoleon	Branch	Leased ⁽⁶⁾

- (1) Four-year lease terminating on December 31, 2004. Annual lease of \$26,150.
- (2) The Association owns the West half of the building.
- (3) Five-year lease terminating February 28, 2007. Annual lease of \$13,740.
- (4) Three-year lease terminating November 30, 2004. Annual lease of \$16,548.
- (5) Five-year lease terminating December 31, 2005. Annual lease of \$16,800.
- (6) Ten-year lease terminating February 14, 2012. Annual lease of \$13,800.

Legal Proceedings

Information, if any, to be disclosed in this section is incorporated herein by reference to Note 12 to the consolidated financial statements, "Commitments and Contingencies," included in this annual report to stockholders.

Description of Capital Structure

Information to be disclosed in this section is incorporated herein by reference to Note 7 to the consolidated financial statements, "Members' Equity," included in this annual report to stockholders.

Description of Liabilities

The description of liabilities, contingent liabilities and intrasystem financial assistance rights and obligations to be disclosed in this section is incorporated herein by reference to Notes 2, 6, 10 and 12 to the consolidated financial statements included in this annual report to stockholders.

Management’s Discussion and Analysis of Financial Condition and Results of Operations

“Management’s Discussion and Analysis of Financial Condition and Results of Operations,” which appears in this annual report to stockholders and is to be disclosed in this section, is incorporated herein by reference.

Senior Officers

The following represents certain information regarding the senior officers of the Association:

Senior Officer Position

Neil Jordan	President and Chief Executive Officer
Alice Beers	Secretary/Treasurer
Mark Pepple	Vice President – Corporate Services
Bruce Leimbach	Vice President – Marketing
Clem Prenger	Internal Auditor

The business experience for the past five years for senior officers is with the Farm Credit System.

The total amount of compensation earned by all senior officers as a group during the years ended December 31, 2003, 2002 and 2001, is as follows:

Aggregate Number of Senior Officers	Year	Annual		Total
		Salary	Bonus	
5	2003	\$458,556	\$50,957	\$509,513
5	2002	\$433,186	\$35,937	\$469,123
5	2001	\$420,842	\$40,360	\$461,202

In addition to a base salary, Association employees earn additional compensation under a bonus/incentive plan. The Association bonus plan is designed to motivate employees to exceed the business plan goals during the fiscal year. These goals typically include return on equity, credit quality, credit administration, loan volume and net income. Bonuses/incentives are shown in the year earned, which may be different from the year of payment.

Disclosure of the total compensation earned in 2003 by any senior officer, or by any other individual included in the total whose compensation exceeds \$50,000, is available to stockholders upon request.

Directors

Directors and senior officers are reimbursed on an actual cost basis for all expenses incurred in the performance of official duties. Such expenses may include transportation, lodging, meals, tips, tolls, parking of cars, registration fees, and other expenses associated with travel on official business. A copy of the policy is available to shareholders of the Association upon request.

The aggregate amount of reimbursement for travel, subsistence and other related expenses for all directors as

a group was \$32,224 for 2003, \$36,170 for 2002, and \$27,975 for 2001.

Subject to approval by the board, the Association may allow directors honoraria of \$250 for attendance at regular meetings, \$200 for attending committee meetings or special assignments and \$50 for conference calls. Total compensation paid to directors, as a group was \$38,350

The following represents certain information regarding the directors of the Association:

Dennis Schroeder, Chairman, represents Paulding, Putnam and Van Wert Counties. For the past five years, his principal occupation and employment was farming and his trucking business. Mr. Schroeder also serves as a Van Buren Township Trustee in Putnam County. He received \$2,500 for attending 10 monthly meetings and \$2,700 for attending 14 other board functions. Mr. Schroeder was elected in 2002 to a three-year term that will expire in 2005.

Tom Antesberger, Vice-Chairman, farms in Sandusky County and represents Ottawa and Sandusky counties and eastern Lucas County. For the past five years, his principal occupation and employment was farming. Mr. Antesberger is a member of the Sandusky County S.W.C.D. He received \$2,500 for attending 10 regular board meetings and \$1,600 or attending 8 other board functions. Mr. Antesberger was elected to a three-year term in 2001 that will expire in 2004.

Melvin Boecher represents Hardin and Hancock Counties. He is a member of the Hardin County Agricultural Society. For the past five years, Mr. Boecher’s principal occupation and employment was farming. He received \$2,500 for attending 10 regular board meetings and \$2,400 for attending 12 other board functions. Mr. Boecher was elected in 2001 to a three-year term that will expire in 2004.

Gerald Bumb represents Seneca County. For the past five years, his principal occupation and employment was farming. He received \$1,750 for attending 7 monthly board meetings and \$1,400 for attending 7 other board functions. Mr. Bumb was elected in 2003 to a three-year term that will expire in 2006.

Bob Borough represented Seneca County. Mr. Borough’s three-year term, which began in 2000, expired in 2003. For the past five years, his principal occupation and employment was farming. He received \$750 for attending 3 monthly board meetings and \$400 for attending 2 other board functions.

Charles Bostdorff farms in Wood County and represents Wood and Henry Counties and western Lucas County. For the past five years, his principal occupation and employment was farming and a greenhouse operation.

He received \$2,500 for attending 10 regular board meetings and \$2,400 for attending 12 other board functions. Mr. Bostdorff was elected in 2001 to a three-year term that will expire in 2004.

Harold Dalton represents Erie, Huron and Lorain Counties. For the past five years, his principal occupation and employment was farming. He received \$2,500 for attending 10 regular board meetings and \$2,000 for attending 10 other board functions. Mr. Dalton was elected in 2003 to a three-year term that will expire in 2006.

Allen Hartschuh represents Crawford and Morrow Counties. For the past five years, his principal occupation and employment was farming. He is a past director on the Crawford County Soil and Water Conservation District. He received \$2,500 for attending 10 monthly meetings and \$1,600 for attending 8 other board functions. Mr. Hartschuh was elected in 2002 to a three-year term that will expire in 2005.

Edison Klingler, Outside Director, is a past County Extension Agent for Hardin County from 1962 to 1988 and is past president of the Ohio Cooperative Extension Agents Association. He was retired for the past five years. He received \$2,250 for attending 9 regular board meetings and \$800 for attending 4 other board functions. The Board appointed Mr. Klingler to the Board in 2002 to serve a three-year term that expires in 2005.

Merrel Lust represents Marion and Wyandot Counties. For the past five years, his principal occupation and employment was farming. He also is a member of the Board of Directors of the AgFirst Farm Credit Bank. He received \$2,500 for attending 10 monthly board meetings and \$800 for attending 4 other board functions. Mr. Lust was elected in 2003 to a three-year term that will expire in 2006.

Transactions with Senior Officers and Directors

The reporting entity's policies on loans to and transactions with its officers and directors, to be disclosed in this section are incorporated herein by reference to Note 11 to the consolidated financial statements, "Related Party Transactions," included in this annual report to stockholders.

Involvement in Certain Legal Proceedings

There were no matters which came to the attention of management or the board of directors regarding involvement of current directors or senior officers in specified legal proceedings which should be disclosed in this section.

Relationship with Independent Public Accountants

There were no material disagreements with our independent public accountants on any matter of accounting principles or financial statement disclosure during this period.

Consolidated Financial Statements

The consolidated financial statements, together with the report thereon of PricewaterhouseCoopers LLP dated February 19, 2004, and the report of management, which appear in this annual report to stockholders are incorporated herein by reference.

Copies of the Association's quarterly reports are available upon request free of charge by calling 1-419-435-7758, ext. 123, or writing Alice Beers, Treasurer, Ag Credit Agricultural Credit Association, 610 West Lytle Street, Fostoria, OH 44830.

Borrower Information Regulations

Since 1972, Farm Credit Administration (FCA) regulations have required that borrower information be held in strict confidence by Farm Credit System (FCS) institutions, their directors, officers and employees. These regulations provide Farm Credit institutions clear guidelines for protecting their borrowers' nonpublic personal information.

On November 10, 1999, the FCA Board adopted a policy that requires FCS institutions to formally inform new borrowers at loan closing of the FCA regulations on releasing borrower information and to address this information in the annual report to shareholders. The implementation of these measures ensures that new and existing borrowers are aware of the privacy protections afforded them through FCA regulations and Farm Credit System institution efforts.

Stockholder Investment

Stockholder investment in the Association could be affected by the financial condition and results of operations of AgFirst Farm Credit Bank. Copies of the District annual and quarterly reports are available upon request free of charge by calling 1-800-845-1745, ext. 503, or writing Patti Trotter, AgFirst Farm Credit Bank, P. O. Box 1499, Columbia, SC 29202. Information concerning AgFirst Farm Credit Bank can also be obtained by going to AgFirst's website at www.agfirst.com.

Report of Independent Auditors



PricewaterhouseCoopers LLP
10 Tenth Street, Suite 1400
Atlanta, GA 30309
Telephone (678) 419 1000

Report of Independent Auditors

February 19, 2004

To the Board of Directors and Stockholders
of Ag Credit Agricultural Credit Association

We have audited the accompanying consolidated balance sheets of Ag Credit Agricultural Credit Association (Association) and its subsidiaries as of December 31, 2003, 2002, and 2001, and the related consolidated statements of income, of changes in members' equity, and of cash flows for each of the three years in the period ended December 31, 2003. These financial statements are the responsibility of the Association's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Association and its subsidiaries at December 31, 2003, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003 in conformity with accounting principles generally accepted in the United States of America.

PricewaterhouseCoopers LLP

Consolidated Balance Sheets

(dollars in thousands)	December 31, 2003	December 31, 2002	December 31, 2001
Assets			
Cash	\$ 363	\$ 110	\$ 547
Loans	597,523	561,446	499,059
Less: allowance for loan losses	11,042	10,262	8,803
Net loans	586,481	551,184	490,256
Accrued interest receivable	10,543	11,218	11,891
Investment in AgFirst Farm Credit Bank	4,206	4,206	4,206
Premises and equipment, net	1,757	1,898	2,052
Other property owned	—	—	38
Other assets	5,029	5,086	4,007
Total assets	<u>\$ 608,379</u>	<u>\$ 573,702</u>	<u>\$ 512,997</u>
Liabilities			
Notes payable to AgFirst Farm Credit Bank	\$ 511,870	\$ 485,258	\$ 428,810
Accrued interest payable	1,406	1,519	1,588
Patronage refund payable	2,587	2,367	2,329
Other liabilities	5,082	7,061	4,955
Total liabilities	<u>520,945</u>	<u>496,205</u>	<u>437,682</u>
Commitments and contingencies			
Members' Equity			
Capital stock and participation certificates	12,270	8,908	9,217
Retained earnings			
Allocated	33,503	27,254	24,768
Unallocated	41,661	41,335	41,330
Total members' equity	<u>87,434</u>	<u>77,497</u>	<u>75,315</u>
Total liabilities and members' equity	<u>\$ 608,379</u>	<u>\$ 573,702</u>	<u>\$ 512,997</u>

The accompanying notes are an integral part of these financial statements.

Consolidated Statements of Income

(dollars in thousands)	For the year ended December 31,		
	2003	2002	2001
Interest Income			
Loans	\$ 32,029	\$ 31,434	\$ 36,172
Interest Expense			
Notes payable to AgFirst Farm Credit Bank	17,371	18,901	23,200
Other	1	3	23
Total interest expense	17,372	18,904	23,223
Net interest income	14,657	12,530	12,949
Provision for (reversal of) loan losses	840	1,500	2,000
Net interest income after provision for (reversal of) loan losses	13,817	11,030	10,949
Noninterest Income			
Loan fees	612	383	374
Fees for financially related services	420	285	322
Patronage refund from AgFirst Farm Credit Bank	4,081	3,636	2,982
Gains (losses) on other property owned, net	(6)	(9)	(8)
Other noninterest income	14	(21)	1,321
Total noninterest income	5,121	4,274	4,991
Noninterest Expense			
Salaries and employee benefits	4,995	4,364	3,899
Occupancy and equipment	469	505	525
Insurance Fund premium	633	156	—
Other operating expenses	1,384	1,384	1,235
Total noninterest expense	7,481	6,409	5,659
Income before income taxes	11,457	8,895	10,281
Provision (benefit) for income taxes	155	213	(3,775)
Net income	\$ 11,302	\$ 8,682	\$ 14,056

The accompanying notes are an integral part of these financial statements.

Consolidated Statements of Changes in Members' Equity

(dollars in thousands)	Capital Stock and Participation Certificates	Retained Earnings		Total Members' Equity
		Allocated	Unallocated	
Balance at December 31, 2000	\$ 14,774	\$ 20,538	\$ 37,481	\$ 72,793
Net income			14,056	14,056
Capital stock/participation certificates issued	2,305			2,305
Capital stock/participation certificates retired	(7,862)			(7,862)
Cash dividends declared/paid			(209)	(209)
Patronage distribution				
Cash			(2,247)	(2,247)
Qualified allocated surplus		1,210	(1,210)	—
Nonqualified allocated surplus		3,227	(3,227)	—
Nonqualified retained surplus		3,227	(3,227)	—
Retained earnings retired		(3,518)		(3,518)
Distribution adjustment		84	(87)	(3)
Balance at December 31, 2001	9,217	24,768	41,330	75,315
Net income			8,682	8,682
Capital stock/participation certificates issued	1,179			1,179
Capital stock/participation certificates retired	(1,488)			(1,488)
Cash dividends declared/paid			(131)	(131)
Patronage distribution				
Cash			(2,294)	(2,294)
Qualified allocated surplus		1,235	(1,235)	—
Nonqualified allocated surplus		2,501	(2,501)	—
Nonqualified retained surplus		2,501	(2,501)	—
Retained earnings retired		(3,763)		(3,763)
Distribution adjustment		12	(15)	(3)
Balance at December 31, 2002	8,908	27,254	41,335	77,497
Net income			11,302	11,302
Capital stock/participation certificates issued	5,777			5,777
Capital stock/participation certificates retired	(2,415)			(2,415)
Cash dividends declared/paid			(158)	(158)
Patronage distribution				
Cash			(2,444)	(2,444)
Qualified allocated surplus		1,629	(1,629)	—
Nonqualified allocated surplus		2,005	(2,005)	—
Nonqualified retained surplus		4,678	(4,678)	—
Retained earnings retired		(2,104)		(2,104)
Distribution adjustment		41	(62)	(21)
Balance at December 31, 2003	\$ 12,270	\$ 33,503	\$ 41,661	\$ 87,434

The accompanying notes are an integral part of these financial statements.

Consolidated Statements of Cash Flows

(dollars in thousands)	For the year ended December 31,		
	2003	2002	2001
Cash flows from operating activities:			
Net income	\$ 11,302	\$ 8,682	\$ 14,056
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation on premises and equipment	242	318	476
Amortization of discount	(249)	(269)	(513)
Provision for (reversal of) loan losses	840	1,500	2,000
(Gains) losses on other property owned, net	6	9	8
(Gains) losses from sale of premises and equipment, net	3	(1)	29
Changes in operating assets and liabilities:			
(Increase) decrease in accrued interest receivable	675	673	2,275
(Increase) decrease in other assets	57	(1,079)	(342)
Increase (decrease) in accrued interest payable	(113)	(69)	(581)
Increase (decrease) in other liabilities	(1,979)	2,106	455
Total adjustments	(518)	3,188	3,807
Net cash provided by (used in) operating activities	10,784	11,870	17,863
Cash flows from investing activities:			
Net (increase) decrease in loans	(36,128)	(62,202)	(56,377)
Purchase of premises and equipment, net	(122)	(213)	(222)
Proceeds from sale of premises and equipment, net	18	50	365
Proceeds from sale of other property owned	234	72	—
Net cash provided by (used in) investing activities	(35,998)	(62,293)	(56,234)
Cash flows from financing activities:			
Advances on (repayment of) notes payable to AgFirst Farm Credit Bank, net	26,612	56,448	49,576
Capital stock and participation certificates issued	5,777	1,179	2,305
Capital stock and participation certificates retired	(2,415)	(1,488)	(7,862)
Patronage refunds paid	(2,403)	(2,390)	(2,498)
Retained earnings retired	(2,104)	(3,763)	(3,518)
Net cash provided by (used in) financing activities	25,467	49,986	38,003
Net increase (decrease) in cash	253	(437)	(368)
Cash, beginning of period	110	547	915
Cash, end of period	\$ 363	\$ 110	\$ 547
Supplemental schedule of non-cash investing and financing activities:			
Loans transferred to other property owned	\$ 240	\$ 43	\$ 46
Cash dividends or patronage distributions declared or payable	2,602	2,425	2,456
Supplemental information:			
Interest paid	\$ 17,485	\$ 18,973	\$ 23,804
Taxes paid, net	148	199	257
Federal tax refunds related to long-term operations (Note 9)	—	—	4,014

The accompanying notes are an integral part of these financial statements.

Notes to the Consolidated Financial Statements

(dollars in thousands, except as noted)

Note 1 — Organization and Operations

A. **Organization:** Ag Credit Agricultural Credit Association (the Association) is a member-owned cooperative which provides credit and credit-related services to or for the benefit of eligible borrowers/stockholders for qualified purposes in the counties of Huron, Erie, Lorain, Paulding, Putnam, Van Wert, Henry, Lucas, Wood, Hancock, Ottawa, Sandusky, Seneca, Wyandot, Marion, Hardin, Crawford and Morrow in the state of Ohio.

The Association is a lending institution of the Farm Credit System (the System), a nationwide system of cooperatively owned Banks and Associations, which was established by Acts of Congress to meet the credit needs of American agriculture and is subject to the provisions of the Farm Credit Act of 1971, as amended (the Farm Credit Act). The most recent significant amendment to the Farm Credit Act was the Agricultural Credit Act of 1987. At December 31, 2003, the System was comprised of four Farm Credit Banks and one Agricultural Credit Bank and numerous Associations.

Effective January 1, 2001, pursuant to a plan of restructuring approved by the Farm Credit Administration (FCA) and Association shareholders, the Association reorganized its existing organizational structure. Pursuant to this restructuring, an FLCA and a PCA were formed as wholly owned subsidiaries of the Association. The formation of these subsidiaries enables the Association to take advantage of the tax-exempt status of net income from long-term mortgage operations of the FLCA. This restructuring was accounted for as a reorganization of entities under common control similar to a pooling of interests.

Prior to the restructuring, the ACA was subject to federal and state income tax. As a result of the restructuring, long-term lending activity was separated into a wholly owned FLCA subsidiary, which is exempt from federal and state income tax. The ACA, which is the holding company, along with the wholly owned PCA subsidiary, continue to be subject to income tax.

AgFirst Farm Credit Bank (Bank) and its related Associations are collectively referred to as the "District." The Bank provides funding to all associations within the District and is responsible for supervising certain activities of the District Associations, as well as the other associations operating within the AgFirst District. The District consists of the Bank and twenty-four ACAs, twenty-two of which have reorganized as ACA parent-companies, which have two wholly owned subsidiaries, an FLCA and a PCA.

ACA parent-companies provide financing and related services through its FLCA and PCA subsidiaries. The FLCA makes secured long-term agricultural real estate and rural home mortgage loans. The PCA makes short- and intermediate-term loans for agricultural production or operating purposes.

Effective December 31, 2002, the assets of the PCA were transferred to the ACA. Short-term lending is now processed in the ACA.

The FCA is delegated authority by Congress to regulate the System banks and associations. The activities of the associations are examined by the FCA and certain actions by the associations are subject to the prior approval of the FCA and the supervising Bank.

The Farm Credit Act established the Farm Credit System Insurance Corporation (Insurance Corporation) to administer the Farm Credit Insurance Fund (Insurance Fund). The Insurance Fund is required to be used to (1) ensure the timely payment of principal and interest on Systemwide debt obligations (Insured debt), (2) ensure the retirement of protected borrower capital at par or stated value, and (3) for other specified purposes. The Insurance Fund is also available for discretionary uses by the Insurance Corporation of providing assistance to certain troubled System institutions and to cover the operating expenses of the Insurance Corporation. Each System bank is required to pay premiums into the Insurance Fund, based on its annual average loan principal outstanding until the monies in the Insurance Fund reach the "secure base amount," which is defined in the Farm Credit Act as 2.0 percent of the aggregate insured obligations (Systemwide debt obligations). When the amount in the Insurance Fund exceeds the secure base amount, the Insurance Corporation is required to reduce premiums, but it still must ensure that reduced premiums are sufficient to maintain the level of the Insurance Fund at the secure base amount.

B. **Operations:** The Farm Credit Act sets forth the types of authorized lending activity, persons eligible to borrow, and financial services which can be offered by the Association. The Association is authorized to provide, either directly or in participation with other

lenders, credit, credit commitments and related services to eligible borrowers. Eligible borrowers include farmers, ranchers, producers or harvesters of aquatic products, rural residents, and farm-related businesses.

The Association may sell to any Farm Credit borrowing member, on an optional basis, credit or term life insurance appropriate to protect the loan commitment in the event of death of the debtor(s). The sale of other insurance necessary to protect a member's farm or aquatic unit is permitted, but limited to hail and multi-peril crop insurance, and insurance necessary to protect the facilities and equipment of aquatic borrowers.

Upon request, stockholders of the Association will be provided with an AgFirst Farm Credit Bank Annual Report to Stockholders, which includes the combined financial statements of the Bank and its related Associations. The Association's financial condition may be impacted by factors that affect the Bank. The AgFirst Annual Report discusses the material aspects of the District's financial condition, changes in financial condition, and results of operations. In addition, the AgFirst Annual Report identifies favorable and unfavorable trends, significant events, uncertainties and the impact of activities of the Financial Assistance Corporation Assistance Board (Assistance Board) and Insurance Corporation.

The lending and financial services offered by the Bank are described in Note 1 of the District's Annual Report to Stockholders.

Note 2 — Summary of Significant Accounting Policies

The accounting and reporting policies of the Association conform with accounting principles generally accepted in the United States of America (GAAP) and prevailing practices within the banking industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Significant estimates are discussed in these footnotes, as applicable. Actual results may differ from these estimates.

Certain amounts in prior years' financial statements have been reclassified to conform to current consolidated financial statement presentation. Such reclassifications had no effect on net income or total members' equity of prior years. The consolidated financial statements include the accounts of the FLCA and the PCA. All significant inter-company transactions have been eliminated in consolidation.

- A. **Cash:** Cash, as included in the statement of cash flows, represents cash on hand and on deposit at banks.
- B. **Loans and Allowance for Loan Losses:** Long-term real estate mortgage loans generally have maturities ranging up to 30 years. Substantially all short- and intermediate-term loans for agricultural production or operating purposes have maturities of 10 years or less.

Loans are carried at their principal amount outstanding less unearned income. Interest on loans is accrued and credited to interest income based upon the principal amount

outstanding. Loans are generally placed in nonaccrual status when principal or interest is delinquent for 90 days or more (unless adequately secured and in the process of collection) or circumstances indicate that collection of principal and/or interest is in doubt. When a loan is placed in nonaccrual status, accrued interest deemed uncollectible is either reversed (if accrued in the current year) or charged against the allowance for loan losses (if accrued in prior years).

When loans are in nonaccrual status, the interest portion of payments received in cash is generally recognized as interest income if collection of the recorded investment in the loan is fully expected and the loan does not have a remaining unrecovered prior charge-off associated with it. Otherwise, loan payments are applied against the recorded investment in the loan asset. Nonaccrual loans may be transferred to accrual status when principal and interest are current, prior charge-offs have been recovered, the ability of the borrower to fulfill the contractual repayment terms is fully expected and the loan is not classified "doubtful" or "loss."

In cases where a borrower experiences financial difficulties and the Association makes certain monetary concessions to the borrower through modifications to the contractual terms of the loan, the loan is classified as a restructured loan. If the borrower's ability to meet the revised payment schedule is uncertain, the loan is classified as a nonaccrual loan.

The allowance for loan losses is maintained at a level considered adequate by management to provide for probable losses inherent in the loan portfolio. The allowance is based on a periodic evaluation of the loan portfolio by management in which numerous factors are considered, including economic conditions, loan portfolio composition and prior loan loss experience. It is based on estimates, appraisals and evaluations of loans which, by their nature, contain elements of uncertainty and imprecision. The possibility exists that changes in the economy and its impact on borrower repayment capacity will cause these estimates, appraisals and evaluations to change.

A specific allowance may be established for impaired loans under SFAS No. 114. Impairment of these loans is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as practically expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. The Bank and Associations record specific allowances to reduce the carrying amount of the impaired loan to the lower of book value or the fair market value of collateral.

- C. **Investment in AgFirst Farm Credit Bank:** The Association is required to maintain ownership in the Bank in the form of Class C stock. Accounting for this investment is on the cost plus allocated equities basis. Patronage refunds from the Bank are accrued as earned. The receivable for such patronage refunds is included in other assets.

- D. Other Property Owned:** Other property owned, consisting of real and personal property acquired through a collection action, is recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less costs to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Income and expenses from operations and carrying value adjustments are included in gains (losses) on other property owned.
- E. Premises and Equipment:** Premises and equipment are carried at cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Gains and losses on dispositions are reflected in current operations. Maintenance and repairs are charged to operating expense and improvements are capitalized.
- F. Advanced Conditional Payments:** The Association is authorized under the Farm Credit Act to accept advance payments from borrowers. To the extent the borrower's access to such advance payments is restricted, the advanced conditional payments are netted against the borrower's related loan balance. Advanced conditional payments are not insured. Interest is generally paid by the Association on such accounts.
- G. Employee Benefit Plans:** The employees of the Association participate in a defined benefit retirement plan along with three other associations. The "Projected Unit Credit" actuarial method is used for financial reporting purposes and the "Entry-Age Normal Cost" method for funding purposes.
- The employees of the Association are eligible to participate in the District's thrift/deferred compensation plan (Thrift Plan); a percentage of employee contributions is matched by the Association. Thrift Plan costs are expensed as funded.
- The Association provides certain health care and life insurance benefits to eligible retired employees. Substantially all employees may become eligible for these benefits if they reach normal retirement age while working for the Association. Expenses of \$473, \$301 and \$228 for the years ended December 31, 2003, 2002 and 2001, respectively, were classified as salaries and employee benefits.
- H. Income Taxes:** The Association is generally subject to Federal and certain other income taxes. The Association is eligible to operate as a cooperative that qualifies for tax treatment under Subchapter T of the Internal Revenue Code. Accordingly, under specified conditions, the Association can exclude from taxable income amounts distributed as qualified patronage refunds in the form of cash, stock or allocated surplus. Provisions for income taxes are made only on those taxable earnings that will not be distributed as qualified patronage refunds. The Association distributes patronage on the basis of book income. The Association recognizes deferred tax assets

and liabilities for the expected future tax consequences of the temporary differences between the carrying amounts and tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. The Association records a valuation allowance at the balance sheet dates against that portion of the Association's deferred tax assets that, based on management's best estimates of future events and circumstances, more likely than not (a likelihood of more than 50 percent) will not be realized.

Effective January 1, 2001, the Association formed a tax exempt subsidiary as described in Note 1.

- I. Patronage Refund from AgFirst:** The Association records patronage refunds from the Bank on an accrual basis.

Note 3 — Loans and Allowance for Loan Losses

A summary of loans follows:

	December 31,		
	2003	2002	2001
Long-term farm mortgage	\$ 299,632	\$ 271,352	\$ 241,530
Production and intermediate-term	229,145	230,344	204,359
Rural home	40,679	25,880	19,895
Farm related business	8,067	9,562	10,122
Processing and marketing	1,757	1,352	1,490
Leases	2,477	3,263	2,674
Nonaccruals	4,409	5,320	5,274
Plus: participations purchased	15,929	17,273	18,040
Less: participations sold	(4,572)	(2,900)	(4,325)
Total	\$ 597,523	\$ 561,446	\$ 499,059

The Association's concentration of credit risk in various agricultural commodities is shown in the following table. While the amounts represent the Association's maximum potential credit risk as it relates to recorded loan principal, a substantial portion of the Association's lending activities is collateralized and the Association's exposure to credit loss associated with lending activities is reduced accordingly. An estimate of the Association's credit risk exposure is considered in the determination of the allowance for loan losses.

Total loans at December 31, 2003, 2002 and 2001 consisted of the following commodity types:

Commodity Type	December 31,		
	2003	2002	2001
General Cash Grain	62%	59%	55%
Livestock	14	15	12
Landlords	6	6	5
Rural Home	6	4	2
Horticulture	5	5	6
Other	7	11	20
Total	100%	100%	100%

The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but typically includes farmland and income-producing property, such as crops and livestock, as well as receivables. Long-term real estate loans are secured by the first liens on the underlying real property. Federal regulations state that long-term real estate loans are not to exceed 85 percent (97 percent if guaranteed by a government agency) of the property's appraised value. However, a decline in a property's market value subsequent to loan origination or advances, or other actions necessary to protect the financial interest of the Association in the collateral, may result in the loan to value ratios in excess of the regulatory maximum.

Impaired loans are loans for which it is probable that not all principal and interest will be collected according to the contractual terms.

The following table presents information relating to impaired loans.

	December 31,		
	2003	2002	2001
Nonaccrual loans:			
Current as to principal and interest	\$ 3,889	\$ 4,468	\$ 3,876
Past due	520	852	1,398
Total nonaccrual loans	4,409	5,320	5,274
Impaired accrual loans:			
Restructured accrual loans	546	584	589
Accrual loans 90 days or more past due	—	1,516	134
Total impaired accrual loans	546	2,100	723
Total impaired loans	\$ 4,955	\$ 7,420	\$ 5,997

There were no material commitments to lend additional funds to debtors whose loans were classified as impaired at December 31, 2003.

Interest income is recognized and cash payments are applied on nonaccrual impaired loans as described in Note 2. The following table presents interest income recognized on impaired loans.

	Year Ended December 31,		
	2003	2002	2001
Interest income recognized on nonaccrual loans	\$ 169	\$ 345	\$ 715
Interest income on impaired accrual loans	124	—	68
Interest income recognized on impaired loans	\$ 293	\$ 345	\$ 783

The following table presents information concerning impaired loans as of December 31,

	2003	2002	2001
Impaired loans with related allowance	\$ 2,325	\$ 2,779	\$ 1,556
Impaired loans with no related allowance	2,630	4,641	4,441
Total impaired loans	\$ 4,955	\$ 7,420	\$ 5,997
Allowance on impaired loans	\$ 1,390	\$ 1,609	\$ 1,513

The following table summarizes impaired loan information for the year ended December 31,

	2003	2002	2001
Average impaired loans	\$ 6,310	\$ 6,370	\$ 5,879

A summary of the changes in the allowance for loan losses follows:

	Year Ended December 31,		
	2003	2002	2001
Balance at beginning of year	\$ 10,262	\$ 8,803	\$ 7,729
Provision for (reversal of) loan losses	840	1,500	2,000
Loans charged off	(84)	(62)	(927)
Recoveries	24	21	1
Balance at end of year	\$ 11,042	\$ 10,262	\$ 8,803
Ratio of net charge-offs during the period to average loans outstanding during the period	.01%	.01%	.20%

Note 4 — Investment in AgFirst Farm Credit Bank

The Association is required to maintain ownership in the Bank of Class C stock as determined by the Bank. The Bank may require additional capital contributions to maintain its capital requirements.

Note 5 — Premises and Equipment

Premises and equipment consisted of the following:

	December 31,		
	2003	2002	2001
Land	\$ 353	\$ 353	\$ 353
Buildings and improvements	2,619	2,564	2,555
Furniture and equipment	1,269	1,420	1,326
Equipment held for lease	—	123	467
	4,241	4,460	4,701
Less: accumulated depreciation	2,484	2,562	2,649
Total	\$ 1,757	\$ 1,898	\$ 2,052

Note 6 — Notes Payable to AgFirst Farm Credit Bank

The Association's indebtedness to the Bank represents borrowings by the Association to fund its loan portfolio. This indebtedness is collateralized by a pledge of substantially all of the Association's assets and the terms of the revolving lines of credit are governed by a general financing agreement. Interest rates on both variable and fixed rate notes payable are generally established loan-by-loan based on the Bank's marginal cost of funds, capital position, operating costs and return objectives. The interest rate is periodically adjusted by the Bank based upon agreement between the Bank and Association. The weighted average interest rates on the variable rate notes were

2.32 percent for LIBOR-based loans, 2.22 percent for Prime-based loans, and the weighted average remaining maturities were 5.1 years and 7.2 years, respectively, at December 31, 2003. The weighted average interest rate on the fixed rate and adjustable rate mortgage (ARM) notes payable which are match funded by the Bank was 3.83 percent and the weighted average remaining maturity was 8.1 years at December 31, 2003. The weighted average interest rate on all interest-bearing notes payable was 3.12 percent and the weighted average remaining maturity was 6.9 years at December 31, 2003.

Variable rate and fixed rate notes payable represent approximately 38.06 percent and 61.94 percent, respectively, of total notes payable at December 31, 2003.

The Bank, consistent with FCA regulations, has established limitations on the Association's ability to borrow funds based on specified factors or formulas relating primarily to credit quality and financial condition. At December 31, 2003, the Association's notes payable were within the specified limitations.

Note 7 — Members' Equity

A description of the Association's capitalization requirements, protection mechanisms, regulatory capitalization requirements and restrictions, and equities are provided below.

A. Capital Stock and Participation Certificates

In accordance with the Farm Credit Act and the Association's capitalization bylaws, each borrower is required to invest in Class C stock for agricultural loans, or participation certificates in the case of rural home and farm related business loans, as a condition of borrowing. The initial borrower investment, through either purchase or transfer, must be in an amount equal to two percent of the member's outstanding principal balance or \$1 thousand whichever is less. The Board of Directors may increase the amount of investment if necessary to meet the Association's capital needs. Loans designated for sale or sold into the Secondary Market on or after January 30, 1997 will have no voting stock or participation certificate purchase requirement if sold within 180 days following the date of designation.

The borrower acquires ownership of the capital stock or participation certificates at the time the loan is made, but usually does not make cash investment. The aggregate par value is generally added to the principal amount of the related loan obligation. The Association retains a first lien on the stock or participation certificates owned by borrowers. Retirement of such equities will generally be at the lower of par or book value, and repayment of a loan does not automatically result in retirement of the corresponding stock or participation certificates.

B. Regulatory Capitalization Requirements and Restrictions

FCA's capital adequacy regulations require the Association to achieve permanent capital of seven percent of risk-adjusted assets and off-balance-sheet commitments. Failure to meet the seven percent capital requirement can initiate certain mandatory and possibly additional discretionary actions by FCA that, if undertaken, could have a direct material effect on the Association's financial statements. The Association is prohibited from reducing permanent capital by retiring stock or making certain other distributions to shareholders unless prescribed capital standards are met. FCA regulations also require that additional minimum standards for capital be achieved. These standards require all System institutions to achieve and maintain ratios as defined by FCA regulations. These required ratios are total surplus as a percentage of risk-adjusted assets of seven percent and of core surplus as a percentage of risk-adjusted assets of three and one-half percent. The Association's permanent capital, total surplus and core surplus ratios at December 31, 2003 were 14.91 percent, 12.67 percent and 11.57 percent, respectively.

An FCA regulation empowers it to direct a transfer of funds or equities by one or more System institutions to another System institution under specified circumstances. The Association has not been called upon to initiate any transfers and is not aware of any proposed action under this regulation.

C. Description of Equities

The Association is authorized to issue or have outstanding Classes A Preferred Stock, Class B Common Stock, Class C Common Stock, Class C Participation Certificates and such other classes of equity as may be provided for in amendments to the bylaws in such amounts as may be necessary to conduct the Association's business. All stock and participation certificates have a par or face value of five dollars (\$5.00) per share.

The Association had the following shares outstanding at December 31, 2003:

Class	Protected	Shares Outstanding	
		Number	Aggregate Par Value
A Preferred/Nonvoting	No	1,616,614	\$ 8,083
C Common/Voting	No	783,405	3,917
C Participation Certificates/Nonvoting	No	54,071	270
Total Capital Stock and Participation Certificates		2,454,090	\$ 12,270

Protected common stock and participation certificates are retired at par or face value in the normal course of business. At-risk common stock and participation certificates are retired at the sole discretion of the Board at book value not to exceed par or face amounts, provided the minimum capital adequacy standards established by the Board are met.

Retained Earnings

The Association maintains an unallocated retained earnings account and an allocated retained earnings account. The Board determines the minimum aggregate amount of these two accounts. At the end of any fiscal year, if the retained earnings accounts otherwise would be less than the minimum amount determined by the Board as necessary to maintain adequate capital reserves to meet the commitments of the Association, the Association shall apply earnings for the year to the unallocated retained earnings account in such amounts as may be determined necessary by the Board. Unallocated retained earnings are maintained for each borrower to permit liquidation on a patronage basis.

The Association maintains an allocated retained earnings account consisting of earnings held and allocated to borrowers on a patronage basis. In the event of a net loss for any fiscal year, such allocated retained earnings account will be subject to full impairment in the order specified in the bylaws beginning with the most recent allocation.

The Association has a first lien and security interest on all retained earnings account allocations owned by any borrowers, and all distributions thereof, as additional collateral for their indebtedness to the Association. When the debt of a borrower is in default or is in the process of final liquidation by payment or otherwise, the Association, upon approval of the Board, may order any and all retained earnings account allocations owned by such borrower to be applied on the indebtedness.

Allocated equities shall be retired solely at the discretion of the Board; provided, however, that minimum capital standards established by the FCA and the Board are met. Nonqualified retained surplus is considered to be permanently invested in the Association and as such, there is no plan to revolve or retire this surplus. All nonqualified distributions are tax deductible only when redeemed.

At December 31, 2003, allocated members' equity consisted of \$15,360 of qualified surplus, \$7,729 of nonqualified allocated surplus and \$10,414 of nonqualified retained surplus.

Patronage Distributions

Prior to the beginning of any fiscal year, the Board, by adoption of a resolution, may obligate the Association to distribute to borrowers on a patronage basis all or any portion of available net earnings for such fiscal year or for that and subsequent fiscal years. Patronage distributions are based on the proportion of the borrower's interest to the amount of interest earned by the Association on its total loans unless the Board approves another proportionate patronage basis.

If the Association meets its capital adequacy standards after making the patronage distributions, the patronage distributions may be in cash, authorized stock of the Association, allocations of earnings retained in an allocated members' equity account, or any one or more of

such forms of distribution. Patronage distributions of the Association's earnings may be paid on either a qualified or nonqualified basis, or a combination of both, as determined by the Board. A minimum of 20 percent of the total qualified patronage distribution to any borrower for any fiscal year shall always be paid in cash.

Dividends

The Association may declare dividends on its capital stock and participation certificates. Dividend rates and method of payment are also at the discretion of the Board in accordance with the Association's by-laws.

Dividends may not be declared if, after recording the liability, the Association would not meet its capital adequacy standards. The Association declared dividends for each of the periods included in these financial statements.

Transfer

Classes A Preferred Stock, Class B Common Stock, Class C Common Stock and Participation Certificates may be transferred to persons or entities eligible to purchase or hold such equities.

Impairment

Any net losses recorded by the Association shall first be applied against unallocated members' equity. To the extent that such losses would exceed unallocated members' equity, such losses would be applied consistent with the Association's bylaws and distributed pro rata to each share and/or unit outstanding in the class, in the following order:

1. Class B Common Stock
2. Class C Common Stock and Participation Certificates
3. Class A Preferred Stock

Liquidation

In the event of liquidation or dissolution of the Association, any assets of the Association remaining after payment or retirement of all liabilities should be distributed consistent with the Association's bylaws and pro rata to the holders of the outstanding stock and participation certificates in the following order:

1. Class A Preferred Stock
2. Class B Common Stock
3. Class C Common Stock and Participation Certificates
4. Allocated surplus evidenced by qualified written notices of allocation on the basis of oldest allocations first
5. Allocated surplus evidenced by nonqualified notices of allocation on the basis of oldest allocations first
6. Unallocated surplus accrued after March 31, 1997 on a patronage basis
7. Any remaining assets of the Association after such distribution ratably to the holders of all classes of stock and participation certificates

Note 8 — Income Taxes

The provision (benefit) for income taxes follows:

	Year Ended December 31,		
	2003	2002	2001
Current:			
Federal	\$ —	\$ 39	\$ 80
State	155	174	159
Federal refunds related to long-term lending	—	—	(4,014)
	<u>155</u>	<u>213</u>	<u>(3,775)</u>
Deferred:	—	—	—
Total provision (benefit) for income taxes	<u>\$ 155</u>	<u>\$ 213</u>	<u>\$ (3,775)</u>

In connection with the restructuring discussed in Note 1, deferred tax assets of \$269 relating to the corporate restructuring and long-term lending activities were written off to the valuation allowance as of January 1, 2001 to reflect the change in tax status. Additionally, during 2001, the Association signed a settlement agreement with the IRS resolving the taxability of the prior years' earnings from its long-term mortgage lending activities. This settlement agreement was modeled after one used by another System ACA to reach a settlement agreement with the IRS in August 2000. As a result of this settlement, the Association recorded a tax refund of \$4,014, which is included as a component of the 2001 income tax provision. In addition, the Association recorded \$1,230 in interest related to these refunds, which is included in Other Income for 2001 in the accompanying Consolidated Statements of Income.

The provision (benefit) for income tax differs from the amount of income tax determined by applying the applicable U.S. statutory federal income tax rate to pretax income as follows:

	December 31,		
	2003	2002	2001
Federal tax at statutory rate	\$ 3,895	\$ 3,024	\$ 3,496
State tax, net	102	115	105
Patronage distributions	(1,135)	(908)	(1,285)
Tax-exempt FLCA earnings	(2,764)	(2,077)	(2,210)
Long-term lending related refunds	—	—	(4,014)
Change in deferred tax asset valuation allowance	(8)	—	(32)
Other	65	59	165
Provision (benefit) for income taxes	<u>\$ 155</u>	<u>\$ 213</u>	<u>\$ (3,775)</u>

Deferred tax assets and liabilities result from the following at:

	December 31,		
	2003	2002	2001
Allowance for loan losses	\$ 342	\$ 342	\$ 341
Annual leave	5	8	8
Nonaccrual loan interest	13	13	13
Postretirement benefits other than pensions	21	29	30
Depreciation (reclassified)	32	32	33
Gross deferred tax assets	<u>413</u>	<u>424</u>	<u>425</u>
Valuation allowance	<u>(381)</u>	<u>(389)</u>	<u>(389)</u>
Loan fees	(1)	—	(1)
Pensions	(31)	(35)	(35)
Gross deferred tax liability	<u>(32)</u>	<u>(35)</u>	<u>(36)</u>
Net deferred tax asset (liability)	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

At December 31, 2003, deferred income taxes had not been provided by the Association on approximately \$3.5 million of its investment in the Bank. Management expected that these earnings would not be converted to cash. On the advice of legal counsel, the Association believes the conversion to an investment in the Bank is considered more likely than not to be tax-free.

Note 9 — Employee Benefit Plans

The Association participates in a defined benefit retirement plan with three other District associations. This plan, which covers substantially all employees, is noncontributory. Benefits are based on salary and years of service. Pension costs were determined by an actuary on a separate entity basis. The measurement date for the plan is September 30.

The following table sets forth the obligations and funded status of the retirement plan:

	As of December 31,		
	2003	2002	2001
Change in projected benefit obligation			
Benefit obligation at beginning of year	\$ 4,850	\$ 3,816	\$ 2,926
Service cost	286	226	185
Interest cost	325	284	231
Actuarial loss/(gain)	944	596	598
Benefits paid	(105)	(72)	(124)
Benefit obligations at end of year	<u>6,300</u>	<u>4,850</u>	<u>3,816</u>
Change in plan assets			
Fair value of plan assets at beginning of year	3,946	4,287	5,570
Actual return on plan assets	809	(492)	(1,159)
Employer contributions	383	223	—
Benefits paid	(106)	(72)	—
Expenses	—	—	(124)
Fair value of plan assets at end of year	<u>5,032</u>	<u>3,946</u>	<u>4,287</u>
Funded status (benefit obligation less FV of plan assets)	\$ (1,268)	\$ (904)	\$ 471
Unrecognized net actuarial loss/(gain)	1,668	1,220	(252)
Unrecognized prior service cost	331	409	487
Net amount recognized	<u>\$ 731</u>	<u>\$ 725</u>	<u>\$ 706</u>
Prepaid benefit costs	\$ 731	\$ 725	\$ 706
Accumulated benefit obligation for the defined benefit plan at December 31	<u>\$ 4,350</u>	<u>\$ 3,481</u>	<u>\$ 2,855</u>
Components of net periodic benefit/(income) cost			
Service cost	\$ 286	\$ 226	\$ 185
Interest cost	325	284	231
Expected return on plan assets	(362)	(383)	(498)
Amortization of transition (asset)	—	—	(2)
Amortization of prior service cost	78	78	78
Recognized actuarial (gain)/loss	49	—	(134)
Net periodic benefit (income) cost	<u>\$ 376</u>	<u>\$ 205</u>	<u>\$ (140)</u>
Weighted-average assumptions used to determine net benefit obligations at December 31			
Discount rate	6.25%	6.75%	7.50%
Rate of compensation increase	4.50%	4.00%	4.00%
Weighted-average assumptions used to determine periodic cost at December 31			
Discount rate	6.25%	6.75%	7.50%
Expected long-term return on plan assets	9.00%	9.00%	9.00%
Rate of compensation increase	4.50%	4.00%	4.00%

Plan assets are invested using active investment strategies utilizing multiple investment management firms. Managers within each asset class cover a range of investment styles and

approaches and are combined in a way that controls for capitalization, and style biases (equities), and interest rate anticipation strategies (fixed income) vs. benchmark indices while focusing primarily on issue selection as a means to add value. Risk is controlled through diversification among multiple asset classes, managers, styles, and securities. Risk is further controlled both at the manager and asset class level by assigning excess return and tracking error targets. Monitoring activities take place to evaluate performance against these targets.

The target asset allocation is 45 percent US equity, 25 percent Non-US equity, and 30 percent fixed income.

Allowable investment types include:

US Equity: Common stocks of large, medium, and small companies, which are predominantly US based. Non-US Equity: Equity securities issued by companies domiciled outside the US and in depository receipts, which represent ownership of securities of non-US companies.

Fixed Income: Fixed income securities issued or guaranteed by the US government, and to a lesser extent by non-US governments, or by their respective agencies and instrumentalities, mortgage backed securities, including collateralized mortgage obligations, corporate debt obligations and dollar-denominated obligations issued in the US by non-US banks and corporations (Yankee bonds).

PLAN ASSETS	2003	2002	2001
<u>Asset Category</u>			
Equity securities	\$ 3,603	\$ 2,629	\$ 2,612
Debt securities	1,429	1,317	1,675
	\$ 5,032	\$ 3,946	\$ 4,287

The overall expected long-term rate of return on assets assumption is based on the target asset allocation for Plan assets, capital markets forecasts for asset classes employed, and active management excess return expectations. The total return for bonds is based on an equilibrium yield assumed to be 6 percent for government bonds plus an additional 0.5 percent due to the exposure of corporate debt in an aggregate benchmark, for a total return of 6.5 percent. A 3 percent equity premium is added to arrive at the forecast for equity returns, both foreign and domestic. Equilibrium forecasts are used to reflect Long-term expectations for the asset classes employed. To the extent asset classes are actively managed, an excess return premium is added.

Target allocation for asset categories for 2004 are as follows:

<u>Asset Category</u>	
Equity securities	70%
Debt securities	30%
	100%

The Association also participates in a districtwide Thrift Plan. The Thrift Plan requires the Association to match 100 percent of employee optional contributions up to a maximum employee contribution of 6 percent of total compensation.

The District sponsors a plan providing certain benefits (primarily health care) to its retirees. Certain Association charges related to this plan are an allocation of District charges based on the Association's proportional share of the plan liability.

On December 8, 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act) was signed into law. This act introduces a prescription drug benefit under Medicare (Medicare Part D) as well as a federal subsidy to sponsors of retiree health care benefit plans that provide a benefit that is at least actuarially equivalent to Medicare Part D. Subsidies under the Medicare Act will reduce the current period measurements of benefits expected to be provided in future periods. These financial statements and disclosures do not reflect the effects of the Act. Specific authoritative guidance on the accounting for the federal subsidy is pending and that guidance, when issued, could require changes to previously reported information.

The following is a table of retirement and postretirement benefits expenses (credits):

	2003	2002	2001
Pension	\$ 376	\$ 205	\$ (140)
Thrift/deferred compensation	192	178	171
Other Postretirement benefits	473	301	228
Total	\$ 1,041	\$ 684	\$ 259

Note 10 — Intra-System Financial Assistance

The Farm Credit System Financial Assistance Corporation (Financial Assistance Corporation) was established in 1988 primarily to provide capital to institutions of the System experiencing financial difficulty. Such assistance was funded through the Financial Assistance Corporation's issuance of \$1.261 billion of 15-year U.S. Treasury-guaranteed debt. The interest rates on these issuances range from 8.80 percent to 9.45 percent. The repayment of this debt and related interest is the responsibility of System banks. At December 31, 2003, only \$325 million of Financial Assistance Corporation debt remains outstanding. All other debt has either matured or was called and redeemed.

Each System bank may be required to pay premiums into the Insurance Fund based on its annual average loan principal outstanding. The Bank, in turn, may also assess the Association for insurance premiums based on the average principal outstanding of accrual and nonaccrual loans of the Association for each year. At December 31, 2003, the assets in the Insurance Fund aggregated \$2.033 billion. However, due to the authorized uses of the Insurance Fund, there is no assurance that Fund assets will be available or sufficient to ensure the payment of principal of, or interest on, insured debt securities in the event of a default by any System bank having primary liability thereon.

Note 11 — Related Party Transactions

In the ordinary course of business, the Association enters into loan transactions with officers and directors of the Association, their immediate families and other organizations with which such persons may be associated. Such loans are subject to special approval requirements contained in the FCA regulations and are made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated borrowers.

Total loans to such persons at December 31, 2003 amounted to \$3,745. During 2003, \$3,324 of new loans were made and repayments totaled \$3,278. In the opinion of management, none of these loans outstanding at December 31, 2003 involved more than a normal risk of collectibility.

Note 12 — Commitments and Contingencies

The Association has various commitments outstanding and contingent liabilities.

The Association may participate in financial instruments with off-balance-sheet risk to satisfy the financing needs of its borrowers and to manage their exposure to interest-rate risk. These financial instruments include commitments to extend credit and commercial letters of credit. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements.

Commitments to extend credit are agreements to lend to a borrower as long as there is not a violation of any condition established in the contract. Commercial letters of credit are agreements to pay a beneficiary under conditions specified in the letter of credit. Commitments and letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. At December 31, 2003, \$120,875 of commitments to extend credit and \$52 of standby letters of credit were outstanding.

Since many of these commitments are expected to expire without being drawn upon, the total commitments do not necessarily represent future cash requirements. However, these credit-related financial instruments have off-balance-sheet credit risk because their amounts are not reflected on the Balance Sheet until funded or drawn upon. The credit risk associated with issuing commitments and letters of credit is substantially the same as that involved in extending loans to borrowers and management applies the same credit policies to these commitments. Upon fully funding a commitment, the credit risk amounts are equal to the contract amounts, assuming that borrowers fail completely to meet their obligations and the collateral or other security is of no value. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the borrower.

The Association also participates in standby letters of credit to satisfy the financing needs of its borrowers. These letters of credit are irrevocable agreements to guarantee payments of specified financial obligations. Outstanding standby letters of credit have expiration dates ranging from July 14, 2004 to March 28, 2008.

Note 13 — Disclosures About Fair Value Of Financial Instruments

The following table presents the carrying amounts and fair values of the Association's financial instruments at December 31, 2003, 2002 and 2001. The fair value of a financial instrument is generally defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

Quoted market prices are generally not available for certain System financial instruments, as described below.

Accordingly fair values are based on judgments regarding anticipated cash flows, future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair values of the Association's financial instruments are as follows:

	December 31, 2003		December 31, 2002	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash	\$ 363	\$ 363	\$ 110	\$ 110
Loans	\$ 597,523	\$ 601,304	\$ 561,446	\$ 573,534
Allowance for loan losses	11,042	—	10,262	—
Loans, net	\$ 586,481	\$ 601,304	\$ 551,184	\$ 573,534

Financial liabilities:				
Notes payable to AgFirst Farm Credit Bank	\$ 511,870	\$ 508,023	\$ 485,258	\$ 490,608

	December 31, 2001	
	Carrying Amount	Estimated Fair Value
Financial assets:		
Cash	\$ 547	\$ 547
Loans	\$ 499,059	\$ 500,916
Allowance for loan losses	8,803	—
Loans, net	\$ 490,256	\$ 500,916

Financial liabilities:		
Notes payable to AgFirst Farm Credit Bank	\$ 428,810	\$ 430,000

A description of the methods and assumptions used to estimate the fair value of each class of the Association's financial instruments for which it is practicable to estimate that value follows:

- A. **Cash:** The carrying value is a reasonable estimate of fair value.
- B. **Loans:** Because no active market exists for the Association's loans, fair value is estimated by discounting the expected future cash flows using the Association's current interest rates at which similar loans would be made to borrowers with similar credit risk. As the discount rates are based on the Bank's loan rates, as well as management

estimates, management has no basis to determine whether the fair values presented would be indicative of the value negotiated in an actual sale.

For purposes of determining fair value of accruing loans, the loan portfolio is segregated into pools of loans with homogeneous characteristics based upon repricing and credit risk. Expected future cash flows and interest rates reflecting appropriate credit risk are separately determined for each individual pool.

Fair value of loans in a nonaccrual status is estimated to be the carrying amount less specific reserves.

The carrying value of accrued interest approximates its fair value.

- C. **Investment in AgFirst Farm Credit Bank:** Estimating the fair value of the Association's investment in the Bank is not practicable because the stock is not traded. As described in Note 4, the net investment is a requirement of borrowing from the Bank and is carried at cost plus allocated equities in the accompanying balance sheet. The Association owns 2.48 percent of the issued stock of the Bank as of December 31, 2003 net of any reciprocal investment. As of that date, the Bank's assets totaled \$15.9 billion and shareholders' equity totaled \$955 million. The Bank's earnings were \$177 million during 2003.
- D. **Notes Payable to AgFirst Farm Credit Bank:** The notes payable are segregated into pricing pools according to the types and terms of the loans (or other assets) which they fund. Fair value of the notes payable is estimated by discounting the anticipated cash flows of each pricing pool using the current rate that would be charged for additional borrowings. For purposes of this estimate it is assumed the cash flow on the notes is equal to the principal payments on the Association's loan receivables plus accrued interest on the notes payable. This assumption implies that earnings on the Association's interest margin are used to fund operating expenses and capital expenditures.
- E. **Commitments to Extend Credit and Standby Letters of Credit:** The estimated market value of off-balance-sheet commitments is minimal since the committed rate approximates current rates offered for commitments with similar rate and maturity characteristics and since the related credit risk is not significant.

Note 14 — Quarterly Financial Information (Unaudited)

Quarterly results of operations for the years ended December 31, 2003, 2002 and 2001 follow:

	2003				
	First	Second	Third	Fourth	Total
Net interest income	\$ 3,337	\$ 3,576	\$ 3,913	\$ 3,831	\$ 14,657
Provision for (reversal of) loan losses	420	420	—	—	840
Noninterest income (expense), net	(799)	(615)	(871)	(230)	(2,515)
Net income (loss)	\$ 2,118	\$ 2,541	\$ 3,042	\$ 3,601	\$ 11,302

	2002				
	First	Second	Third	Fourth	Total
Net interest income	\$ 2,999	\$ 3,107	\$ 3,235	\$ 3,189	\$ 12,530
Provision for (reversal of) loan losses	300	300	450	450	1,500
Noninterest income (expense), net	(751)	(757)	(754)	(86)	(2,348)
Net income (loss)	\$ 1,948	\$ 2,050	\$ 2,031	\$ 2,653	\$ 8,682

	2001				
	First	Second	Third	Fourth	Total
Net interest income	\$ 3,432	\$ 3,499	\$ 3,182	\$ 2,836	\$ 12,949
Provision for (reversal of) loan losses	300	450	150	1,100	2,000
Noninterest income (expense), net	(572)	(620)	4,530	(231)	3,107
Net income (loss)	\$ 2,560	\$ 2,429	\$ 7,562	\$ 1,505	\$ 14,056